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VALUE IN TAXATION.

VALUE is concisely defined in standard treatises on political economy as the purchasing power of a commodity. What a thing will exchange for, we are told, determines its value. What it will exchange for in money, determines its price. The older economists tried to distinguish between value in exchange and value in use, and to illustrate their meaning by citing articles which might have little or no exchangeable value and still be highly useful and, *per contra*, articles which might command colossal prices and yet serve no useful purpose. These distinctions, however, have been entirely brushed away by present-day economic writers, who confine the term "value" to what was formerly termed "exchange value" and refer to so-called value in use simply as utility, of which value is the economic measure. Theoretically, all that is necessary to learn the value of an article or service is to put it on the market and ascertain what it will bring either as a cash consideration or in exchange for other articles or services. But in all this we presuppose an absolutely free field of exchange, in which conditions are no more favorable to purchaser than to seller, and a higgling of the market that will bring about a barter on the basis of equivalence of effective utility. Although these conditions are seldom presented in actual life, yet in taxation it becomes necessary to fix as near as may be the relative values of various articles or properties for purposes of assessment, and often without even the possibility of experimental exchange upon the market. The question then becomes a very practical¹ and a very pertinent one, — how and by what standards property values shall be determined in making up valuations which are to constitute the basis of taxation.

¹ This paper embodies observations made by the writer as a member of the Board of Review which passed upon the 1903 assessment roll for the city of Omaha.

In nearly all our American commonwealths the revenue system, at least for local purposes, is built up around the general property tax. The law requires, as a rule, the listing of all property, real and personal, tangible and intangible, at its true fair cash value. The law always has a sale in contemplation — yet a theoretical rather than an actual sale. According to the provisions relating to real estate in a statute which may be taken as typical, the property shall be listed “at its fair value estimated at the price it would bring at a voluntary sale thereof where public notice had been given and a payment of one-third cash and the balance secured by mortgage upon the property.”¹ In other words, not what a thing has sold for, but what it would sell for under certain conditions, is to govern in arriving at value for taxation. The property to be assessed may never have been upon the market and may have no prospect of changing ownership through sale, or if it has a market price, this may include elements quite abnormal; so that in order to estimate its fair cash value allowance must be made for various factors and different criteria must be applied to find a satisfactory measure of value. What then is the determining factor? To answer this question we must examine analytically a number of factors each by itself that, although conflicting, are constantly set up as the real basis for tax valuations.

1. *Sale*. — If the value of a commodity is its purchasing power, why should not a recent sale fix its valuation for assessment and taxation? The fact that a yard of cloth, a piano, or a city lot has just been bought for a given price is certainly good evidence of value, but does it necessarily fix its value? Property is often disposed of at forced sale — not perhaps at auction to the highest bidder, but yet under more or less duress or stress that impels its owner to sacrifice it for less than it ought to command. The most common forms of forced sale are those by receivers of bankrupt concerns and by administrators of estates for whose settlement the heirs are clamoring. National banks are required by the national banking law to

¹ Nebraska Compiled Statutes, ch. lxxvii, “Revenue,” sec. 5.

sell within a stated period real estate acquired in the transaction of business, and in order to unload their real estate holdings they frequently make prices that will move the property in disregard of settled property values. The pressure to sell may come from many different directions, — from necessity of meeting maturing obligations, from indisposition of people changing their place of residence to take their property with them or hold it as absentee owners, from philanthropic or superstitious motives, from selfish interests for advertising purposes.

We may also have forced purchases as well as forced sales, with the consequent price above rather than below fair cash value. The forced purchase is found where a particular piece of real property is needed for a particular purpose, — for access to railway trackage, for a drainage outlet, for right of way for ingress and egress, for completing the symmetry of a store building or a fine residence. A part owner of property, real or personal, may be forced to buy or sell to adjust control. In all these cases a monopoly price is exacted which may never again be maintained, and the purchaser may truly be said to have given more than the property is fairly worth. To assess it for taxation at the purchase price would be over-shooting the mark as much as taking the price of a forced sale would be undervaluing the property.

In connection with sale prices as the basis of tax valuations we occasionally meet complications arising out of the difficulty of separating the different component parts of the transaction. For example, A may be the owner of three pieces of real estate, lots 1, 2 and 3, of which two are desired by B. A asks \$1000 for each lot, and insists upon selling all three or none. B offers \$2000 for lots 1 and 2, and finally compromises by buying all three for \$2500. He regards the purchase price of lot 3 as \$500, and asks to have its assessment for taxation placed at that figure. Or again, a man may buy a tract of land consisting of several pieces, picking up one at a time. The first he may get at a bargain, though forced to pay a fancy price for the last. Manifestly the fair valuation of the entire

property may not be based on the price either of the first or of the last, or yet of the whole. To allow sales such as these to furnish the standard for assessment not only for the property directly concerned, but also for that adjacent or similar to it, — for all valuations must be relative, — would on one side prevent all equity in taxation, and on the other destroy all stability in assessments.

2. *Offer.* — When actual sales prove not altogether trustworthy, mere offers to buy or sell must be subject to equally deceptive vagaries. That a commodity or a piece of real estate is held by its owner at a certain figure, no more fixes its value than that, when placed on the market, only inadequate offers are made for its purchase. One person might offer only a few dollars for a gold nugget weighing a pound, and another hold a paste diamond for the price of a genuine stone; yet neither would give any reasonable indication of the true value which the assessor aims to get at. Property may be on the market for years without eliciting any offer at all. Yet no one would contend that it had lost its value or that it should be exempted from taxation. The very fact that an offer to buy or sell has failed to ripen into an exchange must be taken to discredit it as the basis for assessing the property, since it proves conclusively that one of the interested parties refused to accept the other's valuation as a proper equivalent.

3. *Cost of Production.* — Cost of production, though closely akin to sale price, is still slightly differentiated from it. The cost of building a house is a good index to value if the work of construction is of recent date, but what it cost to build a house ten years ago, or even last year, is not conclusive evidence of present value. The house may have been extravagantly erected, or it may have been a loss to the contractor. The owner may have put his own labor or supervision into it without including the value of such labor in the cost figures. Some of the construction work may simply have replaced other parts destroyed or discarded. An example in point has come under notice, where a wealthy man, prejudiced against new buildings, bought a residence for \$50,000, — a price generally regarded

as exorbitant, — tore out most of the interior and remodeled the exterior at an additional cost of some \$30,000, and then found the property on the assessment roll for only \$43,000.

For the taxation of intangible personalty the cost of production basis is out of the question. The cost of producing a franchise is indeterminable, while the cost of procuring it through the usual channels depends entirely upon the methods employed. The cost of producing many articles which are joint products or by-products is likewise elusive, because the cost of each component cannot be separated, nor has the cost any direct influence on market price beyond setting limits below which it cannot permanently fall. Cost of production goes up and down, often changing with the seasons, while assessment valuations are made no oftener than once a year. To adjust the tax to either high or low period would work injustice as much as to go back with valuations to cost prices of long ago years.

4. *Cost of Reproduction.* — As a guide to value, cost of reproduction has the advantage of contemporaneity over cost of production, but it is subject to the same limitations, though in perhaps lesser degree. In this connection the question of insurance affords an instructive sidelight, and the amount of insurance carried upon buildings, stocks of merchandise and personal property is often of the utmost assistance to the assessor in making his valuations. Insurance, where carried in full, constitutes the owner's estimate of the cost of replacement or reproduction, in the event of total loss by fire. Property, however, is usually under-insured and only infrequently over-insured. As a rule the eighty per cent clause operates to enforce insurance at least up to that amount, and it is not to be presumed that the prudent business man will pay premiums on policies in excess of the amounts he may recover for destruction of his goods. But it must always be remembered that insurance gives merely a glimpse at an estimate of value and that the estimate of insurable value depends upon the same factors that are considered independently in computing assessments for taxation.

5. *Earning Power.*—If our revenue system were based exclusively on income, earning power alone would be the determining factor in taxation. That we rely for the most part on the property tax, emphasizes the fact that we refuse to recognize earning power as the sole test of ability to pay taxes. But no one would for a moment think of disregarding earning power altogether in arriving at property values. The production of revenue or increment, or at least the capacity, present or prospective, to produce revenue, is what makes property salable, unless it be something that ministers to personal gratification. For real estate the rental value is the chief ingredient of value. This presupposes, however, that the property is improved to its full capacity and also that it is devoted to the most profitable use. Unimproved property from which no rents whatever inure must, however, under our system of property taxation, contribute to the public revenues and be assessed at its fair value proportionably to that which is improved. Again the figures given as rental value often include payments not strictly regardable as rent. The tenant may be paying for heat, power, light, water, telephonic communication, janitor service and many other things in lump sums on a bill rendered for rent. Where real estate investments are expected to net a current rate of interest, it is commonly assumed that a piece of improved property is worth so many months' rent; but for such a computation it is plain that the actual rental value must first be ascertained by excluding all items foreign to the idea of rent.

For mercantile and financial institutions, it is always difficult to isolate the receipts properly definable as earnings on investments. The reward for risk incurred in hazardous undertakings must have allowance as a set-off in estimating property values by earnings. The confidence of the public and more particularly of the patrons in the management of a business institution has much to do with the earnings. Confidence in a bank, for example, might be shaken by some outside incident completely disastrous to its earning power, yet without in the slightest impairing the value of the assets: And the reverse

may happen : a bank with impaired resources may recoup its falling fortunes by a change of responsible management without the addition of a single dollar of new capital. Again, in gauging property values of mercantile concerns for assessment on the basis of earnings, confusion is created by the fact that real earnings are too often hidden. Earnings may be in kind as well as in money, and profits may be distributed through channels other than dividends. Finally, there may be no earnings at all, or even an actual loss, with property values still maintained and still subject to assessment and taxation.

6. *Capitalization.*—The relation of capitalization to the value of the property by which the stocks and bonds are secured is ordinarily direct and proportionate, but still neither the face values of the securities nor yet their market quotations necessarily measure the valuation that should be put upon them for taxation. As every one knows, while capitalization is generally built upon earning power the prices of stocks and bonds can be readily manipulated by various disturbing influences. As there may be hidden earnings, so there may be hidden capital; and there may also be fictitious capitalization based on worthless assets or unfounded promises. In the practical work of assessment for taxation the most perplexing problem presented by capitalization is the determination of the taxable value of a portion of a going concern in one taxing district, as distinguished from other portions outside of the taxing jurisdiction. To cite an example that has come under recent observation: A telephone company doing business in three states was called upon to make return for assessment for city taxation within boundaries that embrace only one of its exchanges, albeit the principal one and the seat of the corporation headquarters. The company contended that, inasmuch as its outstanding securities consisted exclusively of stocks aggregating \$1,798,000 face value, bearing six per cent dividends and selling for par on the market, its entire system must be taken to equal \$1,798,000 in value. In order to ascertain the part returnable for the one exchange in question its officers

prepared an appraisal of all the tangible property, of which \$300,000 in personal property and \$88,000 in real estate was credited to the head office. The remainder, amounting to some \$300,000, left after subtracting the value of the tangible property from the capitalization figures, was then distributed along the line in the same ratio, as representing the franchise value. The resulting return for the part of the plant under consideration embraced \$378,000 as the total personal assessment in addition to the real estate listed at \$88,000. Further inquiry, however, disclosed aggregate earnings for the whole system of \$757,000, of which approximately \$240,000 came from the business transacted through this one exchange. In earning capacity, therefore, the part to be assessed constituted six-nineteenths in value of the entire system, and the capitalization subject to assessment in that taxing jurisdiction figured out \$568,420 instead of \$466,000, as its officers would have preferred; while computed on the basis of net earnings, the proportion of the capital properly represented in the main exchange would have been still greater.

Whether mortgages should be considered as important factors in property valuations is decidedly questionable. A mortgage may arise out of many different conditions. It may represent an unpaid portion of the purchase price; if so, it bears no definite relation to the value of the whole property. It may be merely evidence of part ownership or of a different ownership; as such it is a device resorted to solely for the purpose of obscuring title to protect the real owner, in which the stated consideration may be far in excess of the value of the security. A mortgage anchoring a bond issue indicates nothing more than that the property or business involves borrowed capital in addition to that represented by the shares of capital stock. In some instances, too, the mortgage security covers all the capital actually invested, the stocks being pure water. As a general rule, however, it is safe to assume, in the absence of abnormal features, that mortgaged property is worth at least a considerable percentage of value greater than the face of the obligation.

Conclusion. — From this discussion it might appear that an equitable assessment of property for taxation is an absolute impossibility. But we need have no serious apprehension on that score. No single tax has yet been devised, or is likely to be devised, that will produce automatically a just distribution of the burdens of government. Likewise for the property tax: no one basis of valuation is infallible, but all of them are useful. Not only that, but the one serves to check the other and to offset errors of exaggeration and of depreciation. The most satisfactory assessment of property for taxation will be that made with the fullest knowledge of all the essential factors bearing upon the question of value, while the most defective assessment will be the one that is based upon only one factor to the exclusion of all the others.

VICTOR ROSEWATER.

QMAHA, NEBRASKA.